FOR ARGUMENT

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-1312

DON E. WILLIAMS COMPANY,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

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REPLY BRIEF FOR DON E. WILLIAMS COMPANY

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STATEMENT

This appeal arises out of a complaint brought by the Petitioner, Don E. Williams Company, (hereinafter "Dewco") against the Respondent, Commissioner of Internal Revenue, (hereinafter "C.I.R."). In its complaint Petitioner asked

for a redetermination of the deficiency set forth by the C.I.R. in his Notice of Deficiency dated May 25, 1971.

The deficiency, which Petitioner feels is in error, as determined by the C.I.R. is in income tax as follows and results from disallowance of tax deductions.

Fiscal Year Ending	*Amount of Disallowance*	*Amount/Tax Assessed*
April 30, 1967	$31,589.32	$15,162.87
April 30, 1968	$ 2,743.94	$ 1,360.64
April 30, 1969	$ 1,004.60	$ 530.42

The commissioner erroneously determined for fiscal year ending April 30, 1967, that the delivery of the Petitioner's secured, interest-bearing, negotiable and payable on demand promissory note in the amount of $31,589.32, and within the "grace period" allowed an accrual basis taxpayer by § 404(a)(6) of the Internal Revenue Code of 1954 to the Don E. Williams Company Profit-Sharing Trust, did not constitute payment within the ambit of § 404(a) of the Internal Revenue Code of 1954.

The commissioner erroneously determined for fiscal year ending April 30, 1968, that the delivery of the Petitioner's secured, interest-bearing, negotiable and payable on demand promissory note in the amount of $33,333.26, within the "grace period" allowed an accrual basis taxpayer by § 404(a)(6) of the Internal Revenue Code of 1954 to the Don E. Williams Company Profit-Sharing Trust, did not constitute payment within the ambit of § 404(a) of the Internal Revenue Code of 1954.

The commissioner erroneously determined for fiscal year ending April 30, 1969, that the delivery of the Petitioner's secured, interest-bearing, negotiable and payable on de-

mand promissory note in the amount of $35,337.86, within the "grace period" allowed an accrual basis taxpayer by § 404(a)(6) of the Internal Revenue Code of 1954 to the Don E. Williams Company Profit-Sharing Trust, did not constitute payment within the ambit of § 404(a) of the Internal Revenue Code of 1954.

The fact and exhibits were stipulated to by the parties and the case was submitted to the Tax Court of the United States.

Judgment was entered for the Respondent, with three judges dissenting, assessing deficiencies in income tax due from Petitioner as set forth above.

On appeal, the United States Court of Appeals for the Seventh Circuit affirmed, however, in doing so they declined to follow decisions of the Third, Ninth, and Tenth Circuits and also a district court decision in the Seventh Circuit.

ARGUMENT

I.

THE WORD "PAID" HAS THE SAME MEANING UNDER SECTION 404 AS IT HAS UNDER SECTION 267.

Respondent contends that the "paid" requirement of Section 404(a), Int. Rev. Code of 1954 (Section 23(p), Int. Rev. Code of 1939) (26 U.S.C.) should be interpreted differently than the "paid" requirement of Section 267(a), Int. Rev. Code of 1954 (Section 24(c), Int. Rev. Code of 1939) (26 U.S.C.). For more than twenty years Respondent has recognized that an accrual basis taxpayer satisfies the "paid" requirement of Section 267(a) by delivery of the taxpayer's promissory note. Rev. Rul. 55-608, 1955—2 Cum. Bull, 546, 548. However, Respondent asserts that delivery of its promissory note by an accrual basis taxpayer does not satisfy the "paid" requirement of Section 404(a). In support of his position of different interpretations of "paid", Respondent attempts to distinguish Sections 404(a) and 267(a). Petitioner respectfully submits that Respondent is in error for the following reasons:

First, Respondent ignores the great similarity which exists between Section 404(a) and 267(a). Both sections provide deductions for "trade or business expenses". The deductions under both sections would be allowable deductions under Section 162, Int. Rev. Code of 1954 (Section 23(a), Int. Rev. Code of 1939) (26 U.S.C.) were it not for their separate treatment under Sections 404(a) and 267(a) respectively. Both Section 404(a) and Section 267(a) use the word "paid" rather than the words "paid or incurred" contained in Section 162. Summarizing, both Sections 404(a) and 267(a) evidence Congressional intent to treat certain "trade or business expenses" differently than they would otherwise be treated under the general "Trade or Business Expenses" section (Section 162) and both Sections 404(a) and 267(a) evidence Congressional intent to use the same methodology of differentiation in each Section by use of the single word "paid" rather than the words "paid or incurred". Clearly, a great similarity exists between Section 404(a) and Section 267(a) and no valid reason exists to distinguish them.

Second, in his effort to distinguish Section 404(a) and 267(a) Respondent contends that their respective histories evidence Congressional intent that the word "paid" should be interpreted differently under each section. Petitioner respectfully submits that in making such contention Respondent is clearly in error.

In enacting Section 267 and its predecessor Petitioner respectfully submits that Congress was attempting to "plug a tax loophole". Under Section 162 and its predecessor an accrual basis taxpayer takes the deduction for the "trade or business expense" when incurred and not when paid. However, the cash basis creditor of the accrual basis taxpayer does not report that expense as income until the cash is received, Sections 61 and 451, Int. Rev. Code of 1954 (26 U.S.C.). This dichotomy created no "tax loopholes" for taxpayers dealing at arms length with each other. Although the accrual basis taxpayer could deduct the expense when incurred, ultimately, the creditor must be paid and at that time the income must be reported. However, ingenious tax minds soon discovered that this dichotomy opened a fertile area for "tax loopholes" and "tax shelters" when the accrual basis taxpayer and cash

basis taxpayer were "related" as defined in Section 267 and its predecessor. It was possible to use this dichotomy among "related" taxpayers to enable the accrual basis taxpayer to take the deduction in the year of large income and the cash basis taxpayer to report the income in a year of small income. As submitted, it was to "plug this tax loophole" that motivated Congress to enact Section 267 and its predecessor.

The methodology used by Congress to "plug that tax loophole" evidenced in the enactment of Section 267 and its predecessor was to provide that when the taxpayers are related as defined in said Section the "trade or business expenses" otherwise deductible under Section 162 and its predecessor when "incurred" by an accrual basis taxpayer could only be deducted when "paid" by the accrual basis taxpayer. To alleviate the harshness of Section 267 and its predecessor upon accrual basis taxpayers, Congress did provide therein an additional period of two and one-half months beyond the taxable year in which the expense could be "paid" and still be claimed as an expense for that taxable year.

Subsequent to the enactment of the predecessor to Section 267, litigation arose as to the meaning of the word "paid" as used therein. In that litigation the Commissioner of Internal Revenue contended that "paid" meant "cash" and that the predecessor to Section 267 placed accrual basis taxpayers on the same basis as cash basis taxpayers when the taxpayers were "related" as therein defined. The Courts, other than the Tax Court, uniformly rejected the Commissioner's argument and held that an accrual basis taxpayer satisfies the "paid" requirement of said Section by the delivery of its promissory note. *Musselman Hub-Brake Co.* v. *Commissioner,* 139 F.2d 65 (C.A. 6, 1943); *Celina

Manufacturing Company* v. *Commissioner,* 142 F.2d 449 (C.A. 6, 1944); *Anthony P. Miller, Inc.* v. *Commissioner,* 164 F.2d 268 (C.A. 3, 1947); *Mundet Cork Corporation* v. *Commissioner,* 173 F.2d 757 (C.A. 2, 1949). Thus, an accrual basis taxpayer satisfied the "paid" requirement of the predecessor to Section 267 by the delivery of its promissory note either within its taxable year or during the two and one-half month period beyond its taxable year.

Thus, Petitioner submits that when Congress re-enacted the predecessor to Section 267 into Section 267 under the Internal Revenue Code of 1954, it did so with full knowledge that the Courts, other than the Tax Court, had uniformly held that an accrual basis taxpayer satisfies the "paid" requirements of said Section and its predecessor by the delivery of its promissory note. It did so also with full knowledge that the Commissioner had consistently asserted a contrary position and was still asserting that position. Apparently in response to the rule of construction:

> . . . The re-enactment of a statute substantially unchanged is persuasive indication of adoption by Congress of a prior judicial construction thereof . . . *Commissioner* v. *F. G. Bonfils Trust et al.,* 115 F.2d 788, 792 (C.A. 10, 1940);

the Commissioner in 1955 acquiesced in those Court decisions and conceded that an accrual basis taxpayer satisfies the "paid" requirements of Section 267 by the delivery of its promissory note. Rev. Rul. 55-608, 1955-2 Cum. Bull. 546, 548.

In enacting Section 404 and its predecessor Petitioner respectfully submits that one of the substantial Congressional concerns was the "tax avoidance" which could be possible by virtue of the relationship existing between the payor and payee of the contributions under which that

Section are deductions to the payor taxpayer. See statement of Senator Brown, Senate Hearings Before the Committee on Finance on the Revenue Act of 1942, 77th Cong., 2d Sess. 455, 456 (1942). Under that Section the payor is the employer and the payee(s) are either the employees or a plan for the benefit of the employees. The relationship between employer and employee is frequently not a true "arms length" relationship. Many subtleties exist in that relationship which can provide a direct or indirect control in the employer quite similar to the "related taxpayer" control defined in Section 267 and its predecessor. Because of that similarity Congress quite naturally turned to Section 267 and its predecessor for the methodology to be used in the resolution of its concern.

Petitioner further submits that Congress used the same methodology to solve the problem under Section 404 and its predecessor as it did in solving the problem under Section 267 and its predecessor. It provided that the "trade or business expenses" defined in Section 404 and its predecessor and otherwise deductible under Section 162 and its predecessor when "incurred" by an accrual basis taxpayer could only be deducted when "paid" by the accrual basis taxpayer. Again, as it did under Section 267 and its predecessor, it provided an additional two and one-half months beyond the taxable year in which the expense could be "paid" by the accrual basis taxpayer and still be claimed as an expense for that taxable year.

As was the situation under the predecessor to Section 267, following the enactment of the predecessor to Section 404 litigation arose as to the meaning of "paid" as used therein. At that time the Commissioner was asserting that under the predecessor to Section 267 "paid" meant "cash". Because of the similarity between 267 and 404 and their

respective predecessors, quite naturally the Commissioner contended that under the predecessor to Section 404 the word "paid" meant "cash" just as he was contending it did under the predecessor to Section 267. *Sachs* v. *Commissioner*, 11 T.C.M. 882, Reversed 208 F.2d 313 (1953); *Slaymaker Lock Co.* v. *Commissioner*, 18 T.C. 1001, Reversed Sub. nom in *Sachs* v. *Commissioner*, 208 F.2d 313 (1953); *Logan Engineering Co.* v. *Commissioner*, 12 T.C. 860. As was the case under the predecessor to Section 267, the Commissioner's argument was judicially rejected other than by the Tax Court. The Third Circuit Court in *Sachs* v. *Commissioner, supra,* held that an accrual basis taxpayer satisfies the "paid" requirement of the predecessor to Section 404 by the delivery of its promissory note.

Thus, for many years prior to 1955 the Commissioner contended that the word "paid" as used in both Sections 267 and 404 and their respective predecessors had the same meaning and meant "cash". Petitioner submits that in doing so the Commissioner recognized that the same methodology was used by Congress under both Sections. As previously stated, in 1955 the Commissioner issued Rev. Rul. 55-608, 1955-2 Cum. Bull. 546, 548, and conceded that an accrual basis taxpayer satisfies the "paid" requirements of Section 267 by the delivery of its promissory note. However, in spite of his long standing position that the word "paid" had the same meaning under both Sections, the Commissioner failed to acquiesce in the *Sachs* decision similarly construing the word "paid" under Section 404; and, thus, from the time of the issuance of Rev. Rul. 55-608, 1955-2 Cum. Bull. 546, 548, it became necessary for the Commissioner to contend, as he does in this case, that the word "paid" has a different meaning under Section 404 than he concedes it has under Section 267.

As was the case with Section 267, Congress re-enacted the predecessor to Section 404 into Section 404 under the Internal Revenue Code of 1954. It did so with full knowledge that the Third Circuit Court in *Sachs* v. *Commissioner, supra,* had held that an accrual basis taxpayer satisfied the "paid" requirements of Section 404 by the delivery of its promissory note. It did so also with full knowledge that the Commissioner had consistently asserted a contrary position and was still asserting that position. Accordingly, Petitioner respectfully submits that under the rule of construction enunciated in *Commissioner* v. *F. G. Bonfils Trust et al., supra,* in re-enacting the predecessor to Section 404 into Section 404 substantially unchanged, Congress can be presumed to have adopted the judicial interpretation of the word "paid" under said Section as set forth in the *Sachs* v. *Commissioner, supra,* case. Nevertheless, as stated, the Commissioner inexplicably failed to acquiesce as he did under Section 267.

Further, as stated in Petitioner's Brief and as conceded by Respondent, since the enactment of Section 2003(a) of the Employment Retirement Income Security Act of 1974 (ERISA) Pub. L. 93-406, 88 Stat. 971, the paying of a contribution to the Trust under Section 404(a), Int. Rev. Code of 1954 (26 U.S.C.) with a promissory note is a prohibited transaction. Thus, the subject issue before this Court will have no prospective meaning after the effective date of ERISA, September 2, 1974. Respondent contends that in enacting ERISA and therein prohibiting the funding of the employees' plan with employers' debt obligations Congress was merely reaffirming the intent of Congress many years earlier that the delivery of a note by an accrual basis taxpayer does not satisfy the "paid" requirement of Section 404(a) and its predecessor, Respondent's

Brief, page 25. Petitioner submits that such contention clearly does not comport with the legislative history of ERISA. Further, as previously stated, such contention does not comport with the legislative history of Section 404(a) and its predecessor.

The legislative history of ERISA clearly shows Congressional awareness of "reality" as it existed in 1974. That "reality" was that for many years employers had been borrowing from the employees' plan and evidencing such loan with their debt obligation all in conformity with existing law prior to ERISA. That "reality" was that for many years accrual basis taxpayers had been funding the employees' plan with their debt obligation and that the Courts, other than the Tax Court, had consistently held that the delivery of such note(s) satisfied the "paid" requirements of Section 404(a). This Congressional awareness of "reality" is clearly shown in the pertinent Committee Report on ERISA wherein Congress stated (H.R. Conf. Rep. No. 93-1280, 93d Cong., 2d Sess. 469 (1974)):

> It is intended that prohibited loans include the acquisition by the plan of a debt instrument (such as a bond or note) which is an obligation of a party-in-interest. * * * Similarly, it is intended that it would be a prohibited transaction (in effect a loan by the plant to the employer) if the employer funds his contributions to the plan with his own debt obligations.

Thus, in enacting ERISA Congress clearly showed its awareness and intent to therein prohibit certain transactions which prior to its enactment were proper and legal.

Summarizing, Petitioner respectfully submits that the respective histories of Sections 267 and 404 more reasonably support that the word "paid" has the same meaning under both Sections and does not mean "cash" as Re-

spondent contends Section 404 does and as Respondent contended Section 267 did prior to his acquiescence in 1955. Rather, the respective histories of both Sections support the Congressional intent that the word "paid" means the "transfer of something of value" rather than a mere bookkeeping entry as is permitted under Section 162. Certainly, the delivery of the taxpayer's note to the Trust is the "transfer of something of value". The issue is what is the value of that note. (In this case the Respondent has stipulated that the value of the notes equaled the amount of the claimed deduction by Petitioner.) For years the Commissioner has been engaged in valuing assets such as closely held corporate stock for tax purposes and to require him to value the asset transferred under Section 404 places no inordinate burden upon him.

Third, Respondent attempts to distinguish Sections 267 and 404 by contending that an alleged "tax symmetry" exists under Section 267 which does not exist under Section 404. Respondent suggests that under Section 267 when an accrual basis taxpayer delivers its note to its related cash basis payee there is no need to bar the deduction since the payee must include the corresponding amount in his gross income. Respondent's Brief, p. 28. This is the "tax symmetry" which Respondent alleges exists under Section 267 and not under Section 404. In so contending Respondent is in error as the same alleged "tax symmetry" exists under Section 404. When an accrual basis taxpayer delivers its note to the Trust under Section 404 there is no need to bar the deduction as the payee Trust must include the corresponding amount in its gross income and so report it in its annual information reports to the Internal Revenue Service. Section 6047, Int. Rev. Code of 1954 (26 U.S.C.). Clearly, whatever "tax symmetry" exists under Section 267 also exists under Section 404.

Fourth, Respondent further attempts to distinguish Sections 267 and 404 by stating that the payee under Section 404 is tax exempt thereby inferring that the payee under Section 267 is not tax exempt. In so contending Respondent ignores the express wording of Section 267. Section 267(b)(9) specifically refers to certain educational and charitable tax exempt organizations which are related to the payor taxpayer as therein defined. Clearly, Section 267 applies to both related taxable and tax exempt payees and no distinction can be made between Sections 267 and 404 on that basis. Further, assuming *arguendo* that such distinction was valid, Petitioner respectfully submits that such distinction is artificial and ignores great similarity between those Sections and the identical methodology used by Congress under both Sections.

Fifth, Respondent suggests that an analogy exists between Section 404 and Section 170 of the Int. Rev. Code of 1954 (26 U.S.C.). Respondent's Brief, pp. 22 and 29. However, Respondent cites no authority under Section 170 for treating accrual basis taxpayer's notes in the manner it contends that accrual basis taxpayer's notes should be treated under Section 404. Further, in so contending, Respondent again ignores the great similarity between Sections 267 and 404 and the dissimilarity between Sections 404 and 170. As previously stated, both Sections 267 and 404 provide deductions for "trade or business expenses" which are "paid" and which otherwise would be allowable deductions under Section 162 if "paid or incurred". However, Section 170 provides deductions for charitable contributions which are expressly excluded as "trade or business expenses" under Section 162. Thus, charitable contributions are clearly not "trade or business" expenses under Section 162 and would not be allowable deductions

were it not for the express enactment of Section 170. Summarizing, Petitioner submits that no analogy exists between Sections 404 and 170 and further, assuming *arguendo* that such an analogy exists, no precedent is cited under Section 170 for treating accrual basis taxpayer's notes as Respondent contends Petitioner's notes should be treated under Section 404.

II.

THE UNIFORM COMMERCIAL CODE DOES NOT SUPPORT THE RESPONDENT'S THEORY.

Respondent attempts to support its position by a misconstruction of the Uniform Commercial Code as adopted in Illinois. *Ill.Rev.Stat.* 1963, Ch. 26. The Respondent suggests that the pro-tanto suspension of a debt by the giving of a note does not also apply to a check. Respondent's Brief, pp. 30 and 31. This implication is at best misleading and is clearly contrary to the express wording of *Ill.Rev. Stat.* 1963, Ch. 26, §§3-104, 3-802. 3 Anderson, *Uniform Commercial Code,* pp. 141-142 (2d Ed. 1971).

Section 3-104 of the Illinois version of the Uniform Commercial Code defines both checks and negotiable notes as negotiable instruments. *Ill.Rev.Stat.* 1963, Ch. 26, §3-104. As negotiable instruments both a check and a demand note will discharge the underlying debt pro-tanto until the time of presentment. *Ill.Rev.Stat.* 1963, Ch. 26, §3-802. Respondent states that the pro-tanto suspension of the debt applies to notes but then fails to indicate that the suspension also applies to checks. *Cf.* 3 Anderson, *Uniform Commercial Code,* p. 142 (2d Ed. 1971). After their failure to reveal the similarity between checks and notes the Respondent proceeds to the unwarranted conclusion that demand notes and

checks are totally dissimilar for purposes of satisfying an employer's debt to an employee trust under Section 404(a). Int. Rev. Code of 1954 (26 U.S.C.). As the Illinois version of the Uniform Commercial Code treats both checks and notes the same, with regard to their effect upon the underlying debt, the Respondent's reliance upon the Uniform Commercial Code is erroneous and misplaced.

CONCLUSION

For the reasons stated in Petitioner's Briefs, the judgment of the Court of Appeals below should be reversed and an order entered allowing the deductions for contributions to the Profit Sharing Plan and disallowing any assessment of deficiencies for the taxable years ended April 30, 1967, April 30, 1968 and April 30, 1969.

Respectfully submitted,

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